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MEMORANDUM FOR: DDCI

FROM: Maurice Ernst
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SUBJECT: The Economic Crisis in Bolivia: Is time running out?

The attached memorandum presents a hypothesis on Bolivia's economic crisis. The hypothesis -- that Bolivia is a state of hyperinflation which may be causing a progressive breakdown of economic activity and can only be stopped by extraordinary economic measures -- is based largely on logical extrapolation of the exceedingly negative trends emphasized in the IMF's Staff Report of 20 June 1984. The near absence of recent economic data and the infrequency of pertinent on-the-spot observations prevents any systematic analysis of the issue. Most observers of the Bolivian scene probably will consider the hypothesis to be plausible, but unlikely. My objectives in presenting the hypothesis so starkly are:

a. To alert the interested policy community to the possibility of rapid economic deterioration and political change.

b. To help in better focusing reporting and intelligence collection on Bolivia.

Maurice Ernst

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1. Bolivia may be in a state of hyperinflation which can be stabilized only with drastic economic reforms that the present democratic government is incapable of. The economic deterioration may be accelerating so rapidly that declaration of a state of emergency or a military coup may soon be imperative. Bolivia's foreign debt problems, although severe, for the moment have become largely irrelevant if hyperinflation has taken over the domestic economy.

2. Although Bolivia has been considered an economic basket case for years, political incapacity during the late stages of the military government and even more during the moderate-left democratic government in power since early 1982, has resulted in escalating economic problems. Inflation was over 800 percent at an annual rate in April and may have gone up since. When inflation reaches such astronomical rates, it usually accelerates and severely disrupts the economy.

3. The fundamental problem is the inability of the government to control its expenditures and collect its revenues. The fiscal deficit, which had been running at about 8 percent of GDP in 1979-82, surged to 18 percent of GDP in 1983 and, according to the IMF, would constitute 40 percent of GDP in 1984 in the absence of fundamental reforms. All of the recent deficits are being financed internally -- that is by printing money.

4. The Bolivian government has tried to deal with these problems by doing too little too late. Large devaluations near the beginning and the end of 1982 were quickly offset by domestic inflation. Another devaluation in late 1983 stuck for only 4 months. The currency was devalued again by 400 percent in April 1984, but domestic prices have been catching up rapidly. Numerous other stabilization measures, including price increases for subsidized products, such as petroleum, cuts in public investments, and sharp increases in domestic interest rates, were announced, but implemented only partially, if at all. Widespread strikes and other forms of resistance from organized labor forced wage increases at least matching the inflation rate. The government's incapacity is well illustrated by:

- The inability to make any payments to service foreign debt;

- The fact that COMIBOL, the government enterprise which controls most mineral production and exports, has refused to remit its earnings to the government budget;

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- A several-week strike of Central Bank employees which has halted the printing of money (ironically, perhaps causing a temporary slowing of inflation).

5. It is highly probable that, as inflation accelerates, it is growing much faster than the money supply. From early 1981 through mid 1983, consumer prices and the money supply grew at about the same rates. In the third quarter of 1983, the most recent period for which money supply data are available, prices grew twice as fast as money supply (44 percent as against 22 percent). Since then the rate of inflation has increased several fold and it is reasonable to assume that the growth of money supply has been a great deal slower.

6. A growing discrepancy between inflation and money supply growth should indicate an increased velocity of money -- that is, a tendency for people to spend their money receipts more quickly. A rapidly increasing velocity of money is symptomatic of hyperinflation. People spend money faster because they know its purchasing power will decline quickly if they hold it. This creates a vicious circle of accelerating inflation and creation of money. Eventually, hyperinflation severely disrupts economic activity because people increasingly resort to barter and spend their time buying and selling rather that working at their jobs. It seems quite probable that Bolivia will soon reach, if it has not already reached, the point where hyperinflation causes severe and growing economic disruptions.

7. If this is indeed the situation, there is little foreign creditors or nations can do about it until the domestic economy is stabilized. The only way to stabilize the economy is to take extremely drastic steps, such as:

- A monetary exchange -- issuing, on a fractional basis new currency in return for the existing currency, subject to various conditions, with the old currency ceasing to be legal tender.
- Tight controls over financial transfers and withdrawals;
- A temporary wage and prize freeze;
- Drastic reductions in government subsidies;
- Establishment of a realistic exchange rate;
- Revamping of the tax system.

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8. Given the chaotic political structure, the weakness of the government, and the power of the unions, measures such as these can only be taken if a state of emergency is declared, with the military supporting the present government, or if the military itself takes over the government. In either case there would be high risks of violent reaction from labor and prolonged armed resistance from the left, which the USSR and Cuba could exploit. But there may be no alternative.